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THE IMPACT OF FEDERAL INCOME TAX REFORM

UPON

OFFICE DEVELOPMENT IN DOWNTOWN BOSTON

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October, 1986

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I. SUMMARY

Economists have been analyzing the impact of federal income tax reform upon real estate development in general and upon office development in particular. A study by Kenneth T. Rosen of Salomon Brothers estimates that, nationwide, tax reform will reduce the value of office space by 7 percent over the next several years. This study estimates that the impact upon residential rental property will be much greater. These reductions in value are due to the removal of the tax benefits previously given to real estate. As tax reform will reduce or eliminate these benefits, the total income (including rent and the proceeds from the sale of tax benefits) that a piece of property can generate is reduced. When capitalized into a price, this will lower the value of the property.

This value reduction is also premised, in part, upon the large supply of commercial property that exists in many markets that are either soft or very weak. To the extent that an office market is overbuilt, the impact of tax reform

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A. SUMMARY

Economists have been weighing the impact of federal income tax reform upon real estate development in general and upon office development in particular. A study by Kenneth T. Rosen of [illegible] estimates that tax reform will reduce the value of office space by [illegible] percent over the next several years. This study estimates that the impact upon high-leveraged office property will be much greater. These reductions in value are due to the removal of the tax benefits previously given to real estate. As tax reform will reduce or eliminate these benefits, the total income (including cash and the proceeds from the sale of the property), that a piece of property can generate, is reduced. When capitalized into a price, this will lower the value of the property.

This value reduction is also dependent, in part, upon the large supply of office property that exists in some markets that are either soft or very soft. To the extent that an office market is overbuilt, the impact of tax reform

will be greater as it removes the tax benefits which have carried many properties experiencing low income levels.

The Boston office market is, by contrast, very strong. Rent levels are high relative to development costs; occupancy rates are high and stable; the growth of office based employment is good. Especially for the downtown district, the impact of tax reform upon prime space will be minimal as the income that these properties are earning in the market is providing a competitive return on investment independent of the tax provisions.

Prior to tax reform, the tax incentives that have been given to investors were designed to compensate these investors for accepting the risk associated this type of development. Tax reform removes many of these benefits. This will mean that developments will need to generate a greater cash flow in order to provide the required return on investment.

The projects most effected by this process will be those with lower levels of rental income and those where the tax benefits were central to converting before tax losses into after tax profits. In the past, where the rental income was insufficient to cover operating costs, a development may still have been a worthwhile investment. The property may have produced large excess tax losses that were of value to investors. Syndicating these losses could make the development profitable. For this type of development, the tax benefits tend to comprise both a large

portion of total income and the critical source of income keeping the development competitive. This has often been the case for developments in marginal locations with limited income producing capacity. This would not, generally, be true within a thriving office market experiencing high occupancy rates and high rent levels. While the ownership of a development in a strong market will not ignore the tax benefits, the primary source of value for of this type of development is the rental income.

A recent survey of downtown Boston office building owners conducted by the B.R.A. Research Department questioned these owners as to whether or not they would be influenced by the tax reform measures. Of the individually held buildings 34 percent said that they would be effected by the changes in the depreciation rules. As might be expected, all of those who indicated that they would be effected owned buildings built before 1940 which had been rehabilitated recently. All were under 200,000 square feet, and most were under 50,000 square feet. For those buildings owned by corporations, only 18 percent said that they would be effected. The vast majority of owners of large scale office buildings indicated that tax reform would not change their operation.

This tends to confirm, at least for existing properties, that tax reform will have its greatest impact upon properties at the margin of the marketplace, that is, smaller buildings with lower income earning potential. For

larger scale, higher income properties, the impact will be less. For new, large scale, office developments in the prime locations of downtown Boston, where the rental income is high, tax reform will have some negative impact, but it is not expected to dampen this office development market in any significant manner.

II. THE TAX REFORM BILL

In August of this year, the Congressional Conference Committee on Tax Reform met to resolve differences between the two versions of federal income tax reform recently passed separately by the House and by the Senate. The final compromise version of the tax reform measure has yet to be executed by the administration. However, the tax package has been given a great deal of support from the administration, and acceptance of the bill appears to be very likely.

The Committee reached agreement upon the outline of a bill which has been described in the summary report of the Committee. While many of the details of the tax reform bill have to be resolved through the regulatory process, the basic outline of the compromise version of the bill is known. Based on this outline, it is possible to assess the impact of federal income tax reform upon the development of office space in downtown Boston.

In general, the tax reform package makes three adjustments to the system of income taxation that will

effect the process of office space development. First, tax rates will be reduced for corporations, but a series of new minimum tax provisions will actually bring about an increase in tax revenues collected from corporations. Second, individual taxpayers will have lower tax rates and will face new limitations upon the mixing of income and expenses from different sources. Third, the preferential treatment that the tax laws gave to real estate in the past will be effectively eliminated. The tax benefits which attracted investment to real estate in the recent past will be severely reduced. This will have its greatest impact in the area of residential real estate, but will influence investment decisions in office space as well.

The impact of these changes upon the office development process will depend upon the type of ownership of the office space. If the property is owned by an individual, a partnership or an S corporation, the taxation of the income from the property is a function of the individual income tax provisions. A recent survey of downtown Boston office buildings indicates that about 85 percent of the office buildings are owned in this manner. If the property is owned by a regular corporation, the taxation of the income is based upon corporate income tax provisions as well as the taxation of dividends paid to individual shareholders. The survey of downtown office buildings indicates that the remaining 15 percent of the office buildings are owned in this manner.

III. THE TAX REFORM PROVISIONS

Individual Tax Rates. Under current tax law, individual taxpayers pay taxes across 14 different tax brackets ranging from 11 percent to a high of 50 percent. Under tax reform, there will be only two tax rates plus a surcharge on certain income. The tax rates will be 15 percent on the first taxable income earned by most households and then 28 percent on income higher than $29,750. If the taxpayer has income in excess of $71,900, then a 5 percent surcharge is added to the tax liability so as to eliminate the reduced taxation of the income normally taxed at 15 percent. This surcharge is phased out at higher income levels when the tax benefit of the 15 percent taxation is exhausted. This means that for many upper income taxpayers, the highest marginal tax rate is 33 percent (28 percent plus the 5 percent surcharge). These tax rates will take effect fully during calendar year 1988. During 1987, the tax rates will be blended rates reflecting the new rates as well as the existing rates. During 1987, the rates will range from 11 percent to a high of 38.5 percent.

Individuals will face a new Alternative Minimum Tax (AMT) under tax reform. The individual must pay the higher of the tax calculated through the normal income tax provisions or the tax calculated through the AMT. The AMT is set at 21 percent of normal taxable income plus preference items. There is a $40,000 exemption from this

income amount for joint returns an a $30,000 exemption for individual returns. However, these exemptions are phased out for income greater than $150,000 on joint returns and $112,500 on individual returns. Despite these exemptions, the effect of the AMT is to ensure that all taxpayers will pay some taxes independent of the number of preferences taken to reduce their taxation.

Corporate Income Tax Rates. Under current law the tax rates on corporations cover five brackets to a maximum of 46 percent. Under tax reform, corporate taxes will be paid at a maximum of 34 percent beginning July, 1987. This rate of taxation is lower, however, than the maximum tax rate paid by individuals. This may influence office development in that the ownership of an office development can be structured in a variety of ways. Among the issues that are considered when choosing between the alternative forms of ownership is the level of total taxation paid under each form. If the ownership is a corporation, the income from the property is subject, first, to taxation under the corporate rates and, second, to individual tax rates on dividends that are paid. If the ownership is taxed as an individual, such as is true for S corporations, then only the individual rates are applied to the income.

An Alternative Minimum Tax system is also to be applied to corporate income in much the same way as to individuals. The tax rate for corporations will be 20 percent on all

taxable income plus preference items. An exemption of $40,000 is made for corporations with income at or below $150,000. This exemption is phased out for income greater than $150,000.

Capital Gains Taxation. For both individuals and corporations, capital gains income will be taxed in the same manner as ordinary income. Under current law, the first 60 percent of income realized upon the sale of a capital asset is exempt from taxation if the asset has been held for longer than 6 months. The remaining 40 percent of the capital gain is taxed using the applicable tax rate of the taxpayer. For individuals at the highest marginal tax rate, the effective tax rate on capital gains income is 20 percent (calculated as the 50 percent tax rate multiplied by the 40 percent of the income that is subject to taxation). With tax reform, capital gains income will be treated like ordinary income making the highest marginal tax rate either 28 or 33 percent for individuals or 34 percent for corporations. This change will take effect for any capital asset sold after January 1, 1987.

Depreciation Expenses on Real Property. Under current tax law, commercial property including office space is allowed to deduct from taxable income an amount which reflects the assumed depreciation of the value of the non-land component of the property. Recently, this depreciation expense has

been calculated based upon a 19 year depreciable life span of the property and a 175 percent declining balance basis. This means that the depreciation in the first year of operation of the property is approximately the non-land value divided by 19 years multiplied by the 1.75 acceleration factor. In following years, the same calculation is made using the non-land value net depreciation claimed in prior years. When the amount of depreciation calculated in this manner is less than the amount that would be taken using a simple straight line method, the depreciation calculation switches to the straight method.

With commercial property, any depreciation taken is subject to recapture at the time of the sale of the property. Thus, the large amount of depreciation that is taken in the early years of a property's operation permit the owner to defer taxes until disposition of the property.

Under tax reform, the depreciation expense must be calculated using a 31.5 year depreciable life and a straight line method. This both lengthens the depreciation period which lowers the amount of the depreciation expense and eliminates the process through which more depreciation is permitted in the early years of operation.

For individuals, tax reform places another important limitation upon the use of depreciation losses. Under existing law, the depreciations losses in excess of income can be used to offset income from other sources. That is,

if the property has more depreciation losses than income, the excess losses can be claimed against any of the owner's other income such as salary. This has been the central process upon which the syndication industry has depended. An investor buys into a partnership which owns a property becoming a limited partner. The investor's payment to the general partner is calibrated so as to pay for the tax reducing value of the excess losses that the investor receives from the ownership of the property. For example, if the investor is in the 50 percent tax bracket, each dollar of excess depreciation is worth 50 cents in reduced taxation to the investor. For example, the investor may pay 35 cents for each dollar of depreciation assuming that the difference between the 50 cent benefit and the 35 cent payment appropriately adjusts for the risk associated with such an investment. The general partner receives the payment from the limited partner which can be used either as equity at the time of purchase or as return on the general partner's initial investment. The limited partner realizes reduced taxes through the ability to claim the losses.

Tax reform will severely reduce the ability to form such an arrangement for any type of property, including office space.

Tax reform distinguishes three types of income. First, active income is the income derived from salaries, wages or activities in which the individual is actively involved in the day-to-day management of the operation. Second,

portfolio income is comprised of all interest and dividend income. Third, passive income is all income from sources in which the individual is not actively involved. Rental income is defined in the tax reform bill as passive income. Under tax reform, losses from passive activities cannot be taken against income from active or portfolio sources. There is an exception for relatively small operations, but this prohibition against reducing income with passive losses effectively eliminates the process of syndication for commercial properties. Losses in excess of income derived from a commercial property can be used to offset only income from other passive activities. Given the longer depreciation period and the straight line method of calculation, there will be lower levels of deductible expenses generated. Even if losses are realized in excess of income, the excess losses can only be used to offset taxable income from other similar types of investment such as other commercial property.

Other Changes from Tax Reform. A great many other changes in the system of federal income taxation are included in the tax reform measure. The list above covers those with the greatest impact upon office development. Others that will have some impact include the interest reduction limits, the extension of the at-risk rules to real estate and the construction loan interest deduction.

Briefly, interest paid on mortgage backed loans can only be deducted from income to the extent that the property financed by the loan generating the interest expense has income in equal amounts. Interest deductions will not be allowed in excess of the income produced by a property. In most cases, it has been the accelerated depreciation rather than the interest deduction that has generated value for syndication. As such, this new provision will not severely hinder office development.

The at-risk rules in the income tax code state that deductions cannot be made in excess of the amount for which the taxpayer is "at-risk" in the investment. Normally, this would be very difficult for real estate as investors pay in an equity amount that is a small fraction of the total value of a property; the remainder is financed by mortgage backed borrowing. An exception has been made for real estate exempting it from these rules. Tax reform makes real estate subject to the at-risk rules but the amount at-risk is calculated to include the debt amount for qualified nonrecourse loans. The qualifications generally cover the extent to which the lender can participate in the ownership of the property. In most cases of office development, the rules for lender participation will not be prohibitive. This will permit owners to continue to use the deductions subject to the passive loss limitations listed above.

Construction loan interest has been allowed to be either expensed immediately or over a very short period of

time. This provides greater tax benefit than deducting these interest expenses over a long schedule. Under tax reform, construction loan interest is to be included in the depreciable basis of the property and is deducted through the long term, straight line deprecation method.